Internal Revenue Service

memorandum

CC:TL-N-278-90
Br4:GBFleming

date: JAN 12 1990

to: International Special Trial Attorney,
Southwest Region CC:SW:TL

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

This responds to your memorandum dated September 20, 1989, requesting Tax Litigation Advice concerning the above-captioned litigation. We have coordinated this issue with the Technical function and are providing this response to the legal issue specifically raised by your request. During our discussions concerning this case, you raised additional related issues, and we will supplement our response with respect to those issues upon receiving a complete memorandum from Technical.

ISSUE

Whether petitioner was entitled to a loss deduction under I.R.C. § 165 in [redacted], the year that the petitioner purportedly determined the worthlessness of its working interests in [redacted] leases (based on the results of a dry hole drilled on nearby leases), or not until [redacted] after relinquishing its working interests.

FACTS

In the [redacted], petitioner acquired working interests in [redacted]. Subsequently, in [redacted], petitioner and the other working interest owners of [redacted] entered into the [redacted] ("[redacted] Agreement"). Under that agreement, the lessees of [redacted] agreed to share the exploration costs on those [redacted] tracts, specifically to test the [redacted] within the [redacted] structure. The [redacted] Agreement designated [redacted] ([redacted]) as the operator. In accordance with the Agreement, [redacted] entered into "[redacted]

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agreements" with other companies that were not parties to the [redacted] Agreement but contributed $[redacted] toward the drilling of a well (the "[redacted] well") on the [redacted] tracts in exchange for data obtained from drilling and testing. The geological data available at that time indicated that the [redacted] formation extended under petitioner's other [redacted] tracts, which were located near the [redacted] tracts.

The [redacted] well was spudded in [redacted], and required coring and logging with respect to the [redacted] formation was completed by [redacted]. Based on its analysis of the core samples and logs, petitioner claims to have determined that the [redacted] formation was incapable of producing commercial quantities of oil or other hydrocarbons from the [redacted] drilling site. Petitioner further claims that the core samples and logs also established the absence of commercial quantities of oil or other hydrocarbons in the [redacted] formation, rendering its interests in [redacted] worthless.

On [redacted], petitioner issued a press release stating that the preliminary data "indicate that the [[redacted]] well is dry and it is likely we will write off the investment." On the date of the announcement, petitioner's stock fell $[redacted] per share in trading on the New York Stock Exchange.

[redacted] continued drilling until [redacted], to the depth required by the [redacted] Agreement and the bottom hole agreements. The drilling encountered the [redacted] formation, and the analysis of induction and production logs on [redacted], indicated that the [redacted] formation was not capable of producing commercial quantities of oil or other hydrocarbons. [redacted] performed [redacted] drill stem tests in [redacted] and plugged the well on [redacted]. No parties submitted nominations for a subsequent well in response to [redacted]'s letter of [redacted], and the drilling rig and equipment were demobilized.

On [redacted], petitioner notified [redacted] that it was withdrawing from the [redacted] Agreement. In [redacted], petitioner conveyed by quitclaim deeds its interests in [redacted]. Petitioner had paid the delay rentals on these [redacted] in [redacted] and none were due again until [redacted].

On its return for calendar year [redacted], petitioner deducted its adjusted tax basis in [redacted] on the ground that those [redacted] had become worthless by [redacted]. 1/ Upon examination, those losses were disallowed and are the subject of the above-captioned litigation.

DISCUSSION

The principal question raised by your request is what requirements petitioner had to satisfy in order to take a section 165 loss deduction for [redacted] and when did it satisfy those requirements.

Under I.R.C. § 165(a), a deduction is allowed for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Treas. Reg. § 1.165-1(d)(1) provides generally that the loss is "sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year."

With respect to nondepreciable property, such as oil and gas leases, Treas. Reg. § 1.165-2(a) provides for a deduction of a loss incurred in a business or transaction arising from the "sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or such property is permanently discarded from use therein . . . ." Under the regulation, the loss is allowed for the taxable year in which it is actually sustained, which "is not necessarily the taxable year in which the overt act of abandonment, or the loss of title to the property, occurs."

As indicated by the language quoted above, the regulation clearly contemplates that a taxpayer may generally take a loss deduction before actually relinquishing title to the worthless nondepreciable property.

Applicable case law

A number of cases have addressed the timing of the deduction under section 165 (or predecessor provisions) for worthless mineral properties. In these cases, the Service disallowed the deduction on the ground that the loss was not sustained in the particular tax year in which the taxpayer

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1/ Petitioner also deducted in [redacted] its share of the losses from the [redacted] well. Because the parties to the [redacted] Agreement elected to treat that arrangement as a TEFRA partnership, those losses are subject to a separate partnership examination and are not at issue in the instant Tax Court litigation.

claimed the deduction. The Service's position in these cases generally falls into two categories: (1) the loss was sustained in a year prior to the year in which the deduction was claimed, or (2) the taxpayer claimed the deduction in a year before the loss was actually sustained. Thus, depending on the situation, the courts have had to determine whether the taxpayer was either late or premature in claiming the deduction.

Although it is basically a factual question to determine the tax year in which a loss is sustained, the courts have created some confusion by holding that different requirements are determinative. In some cases, the courts have held that the loss is sustained in the year that the asset becomes worthless, while holding in other cases that the loss is not sustained until the year in which the taxpayer makes an overt act of abandonment. A brief review of the principal cases will illustrate the different standards that the courts have applied.

1.

The Tax Court considered a predecessor of Treas. Reg. § 1.165-2(a) in Harmon v. Commissioner, 1 T.C. 40 (1942), one of the seminal cases in this area. In Harmon, the taxpayer claimed a deduction on his 1939 return for the worthlessness of certain oil and gas royalty interests. The worthlessness claim was based on dry holes that were drilled in 1939 either on the properties to which the taxpayer's royalty interests related or on nearby properties. The taxpayer formally divested himself of these royalty interests by executing quitclaim deeds in 1940. The Service argued that a royalty interest cannot be considered worthless until it is established that there is no possibility of producing oil and gas from any of the underlying sedimentary beds reachable under existing drilling practices. Under the Service's argument, there had to be test drillings on the property or in the immediate vicinity to the bottom of the sedimentary beds in order to establish worthlessness.

The court rejected the Service's argument, concluding that the taxpayer's royalty interests became worthless in 1939 as a result of the dry holes drilled on or in the vicinity of the royalty premises in 1938 and 1939. Accordingly, the court held that the taxpayer was entitled to a loss deduction in 1939.

The court premised its holding on the lack of any indication that the predecessor of I.R.C. § 165 2/ permitted a distinction between losses of different types of property. Because other types of property became worthless upon loss of sale value, the court declined to impose additional conditions on the worthlessness deduction in the case of oil and gas royalties. In the court's view, the mere "possibility" of future production was insufficient to give value to royalty interests that were judged worthless by persons engaged in the trade and familiar with oil and gas development in the relevant areas.

2.

The Harmon court focused on the worthlessness determination and did not specifically discuss whether the taxpayer is required to perform an affirmative act of abandonment in order to claim the deduction. The court's opinion indicates no concern, however, that the taxpayer retained title to the royalties until the year following the year in which the deduction was claimed.

In A. J. Industries, Inc. v. United States, 503 F.2d 660 (9th Cir. 1974), the Ninth Circuit held that the act of abandonment is the necessary predicate for sustaining a loss on assets used in a trade or business. In that case, the taxpayer claimed a loss on its 1958 return for a gold mine located in Alaska. The mine was operated profitably from 1897 to 1942 but was unprofitable in 1943 and 1944 because of rising wartime wages. In 1944, the mine was shut down, but the management believed that the mine could be reopened after the end of World War II. A skeleton work force was maintained to protect equipment and to perform repairs, reconstruction, and exploratory work.

The mine never reopened, but the company's management continued to believe that the mine could eventually be operated again. New management took over in mid-1956 and decided to abandon the mine, giving an option for salvage of the machinery and equipment. The option was exercised in 1957, and the company entered into a contract for the salvage process. In 1958, the board of directors voted to abandon the mine, and the company charged off as worthless the capitalized mine development and preparatory mining costs.

The company claimed a loss on its 1958 return for the capitalized development and preparatory costs, but the

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2/ The controlling provision was section 23(e) of the Revenue Act of 1938.

Service disallowed the loss. In the ensuing refund action, the Court of Claims held that the mine became worthless or lost its useful value prior to 1958. A. J. Industries, Inc. v. United States, 388 F.2d 701 (Ct. Cl. 1967), cert. denied, 393 U.S. 833 (1968). The taxpayer then sought a refund for 1956 or 1957, and litigated the issue in the district court, which held that the loss occurred before 1956. A. J. Industries, Inc. v. United States, 72-2 USTC ¶ 9646 (C.D. Cal. 1972).

Reversing the district court, the Ninth Circuit held that the taxpayer was entitled to a loss deduction in 1957, the year in which the contract for salvage was executed. In reaching that result, the court interpreted the predecessor of Treas. Reg. § 1.165-2 as not requiring or allowing deduction of a loss in the year in which the asset loses its value if the taxpayer does not abandon it because he reasonably believes the asset still has value. 503 F.2d at 668. 3/ In the court's view, a taxpayer does not sustain a deductible loss solely because the asset becomes worthless but must intend to abandon the asset and take some action. Id. 4/ Furthermore, the court accorded great weight to the subjective judgment of the taxpayer concerning whether an asset will have future value, stating that "a court is not justified in substituting its business judgment for a reasonable, well-founded judgment of the taxpayer." 503 F.2d at 670.

3.

In recent cases involving deductions for the abandonment of mineral leases the Tax Court has followed the Ninth Circuit's approach in A. J. Industries. In Brountas v.

3/ Under Treas. Reg. § 1.165-1(d)(4), the taxpayer had the option of applying either the regulations under the 1939 Code or the 1954 Code. The court considered both sets of regulations but focused principally on the regulations under the 1939 Code.

4/ The court recognized that worthlessness is a sufficient basis for claiming the loss deduction in the case of securities (I.R.C. § 165(g)) or bad debts (I.R.C. § 166(a)). Because the Code does not provide any guidance on the loss of business assets, the court looked to the relevant regulations, which speak of situations where the taxpayer "permanently discarded" (Treas. Reg. § 1.165-2(a)) the asset. Thus, the court reasoned that "the 'abandonment' or 'discarding' of an asset would require an act and an intent." 503 F.2d at 665-67.

Commissioner, 73 T.C. 491 (1979), the taxpayers were limited and general partners in drilling ventures that reported abandonment losses with respect to oil and gas leases that were determined to have no further geological merit. The ventures abandoned some leases entirely and discontinued paying delay rentals for those leases. They also determined that certain horizons in other leaseholds were worthless, in which case they reported a loss deduction for a percentage of the purchase price of the lease but continued paying delay rentals on the entire lease.

The Tax Court held that a geological determination of worthlessness and cessation of delay rental payments establish abandonment of a lease. Where payment of delay rentals continued, however, the court held that no abandonment loss was allowable "until there was an unequivocal act of abandonment such as letting a due date of such payments pass without payment." 73 T.C. at 585. Thus, the court barred deductions for the so-called "partial abandonment losses" reported by the drilling ventures. On appeal, both the First and Third Circuits affirmed the Tax Court's decision on this issue. Brountas v. Commissioner, 692 F.2d 152 (1982); CRC Corp. v. Commissioner, 693 F.2d 281 (3d Cir. 1982).

4.

In Gulf Oil Corp. v. Commissioner, 87 T.C. 135 (1986), appeal docketed, Nos. 89-2049 and 89-2050 (3d Cir. December 1, 1989), the taxpayer claimed loss deductions for previously identified potential deposits within various offshore leases. Within a short time after acquiring the leases in question, the taxpayer identified potential mineral deposits within each lease and purportedly elected to treat each potential deposit as a separate operating mineral interest under I.R.C. § 614(b)(2). Subsequently, the taxpayer concluded on the basis of geological data that certain potential deposits were worthless and claimed loss deductions for the worthless deposits. The deduction claimed for each worthless deposit was the amount of the leasehold basis allocable to that deposit. Where only portions of a leasehold were worthless, the taxpayer retained the lease on its books and continued to pay delay rentals on the entire lease.

In discussing the requirements for the loss deduction, the court acknowledged that the subjective judgment of the taxpayer as to the future value of assets is entitled to great weight. In addition, court noted that the taxpayer was not required to sell or otherwise dispose of the properties in order to make a valid claim. Citing its earlier decision in Brountas, the court stated, however, that a reasonable determination of worthlessness must be supported by an act of abandonment.

Looking at the taxpayer's purported abandonment of the potential deposits, the court noted that the taxpayer's payment of the delay rentals preserved its rights to the entire lease, including the purportedly abandoned deposits. Even ignoring the payment of delay rentals, the court was unable to find any objective evidence of the purported abandonment of the deposits and pointed to the lack of an overt act of abandonment. 87 T.C. at 161-66. Accordingly, the court held that the taxpayer had failed to establish that it sustained a loss with respected to the abandoned deposits. 5/

Service Position

The Service's position on abandonment losses for worthless mineral properties has undergone a number of changes in direction. In one of the earliest rulings, the deduction for worthless oil royalties was allowed where "such interests prove worthless, as evidenced by all wells proving dry or failing after producing very small quantities of oil." OD 375, C.B. No. 2 at p. 128 (1920). Later, a more restrictive position was announced, requiring that the lease must have expired or been canceled, or that the owner must have relinquished title during the taxable year. SM 5700, V-1 C.B. 241 (1926). The Board of Tax Appeals rejected this rule, which was relaxed in GCM 3890, VII-1 C.B. 168 (1928), obs., Rev. Rul. 68-661, 68-2 C.B. 609, to allow the deduction upon establishing that there is no oil or gas on the premises.

The timing of a loss deduction under section 23(e) of the 1939 Code was considered in Rev. Rul. 54-581, 1954-2 C.B. 112. The ruling states that "if the loss in the value of property was sustained in a previous year, the taxpayer may not, by subsequent act of abandonment, establish a deductible loss for the year of such abandonment." It was held that the loss is deductible in the year in which it was actually sustained. Moreover, if the loss was sustained in a year prior to the year in which the overt act of abandonment took place, it is not deductible in the year of the act of abandonment.

5/ In the recently docketed appellate proceeding, the taxpayer has indicated that the abandonment issue will be raised in the appeal.

This position was reiterated in Texasgulf, Inc., OM 18856, I-17-75 (September 23, 1977), which considered the timing of an abandonment loss with respect to mineral property. 6/ The memorandum sets forth the following principle:

> We believe that the correct position is that the loss is sustained and the deduction allowed under Code § 165(a) only in the year in which under objective standards the property becomes worthless. Thus, in the difficult case in which the taxpayer does not actually abandon the asset until a later year, the deduction should not be permitted in that later year.

OM 18856 at 12. The underlying premise for this conclusion is that the "loss sustained" is the "loss of value of the asset, not the actual physical abandonment of the asset."

The above conclusion is rationalized with the reference in the regulation to an overt act of abandonment as follows:

> The requirement in the regulations for an overt act of abandonment is not inconsistent with this position because that requirement insures that, in fact, the asset is no longer useful in the taxpayer's trade or business. Moreover, it reflects the recognition in the regulation that the determination of the year in which the loss is sustained may be difficult in some cases, and the action and judgment of the taxpayer is relevant to such a determination. However, this requirement should not be construed to create a "realizing" event that allows a deduction for the loss of usefulness of an asset in a taxable year subsequent to the year in which the usefulness of the asset actually terminated or the asset becomes worthless.

OM 18856 at 13. The memorandum expressly discusses the Ninth Circuit's decision in A. J. Industries and disagrees with the court's conclusion that the act of abandonment is the critical event for determining the year in which the loss is sustained.

6/ A copy of OM 18856 is attached. (The OM is a privileged document and should not be disclosed.)

The Instant Case

As the foregoing discussion demonstrates, the determination of the year in which a loss is sustained cannot be reduced to an exact formula. We believe, however, that it is possible to distill two general requirements for a deduction under section 165(a) for a loss upon the termination of the usefulness of a business asset. First, there must be an identifiable event or transaction establishing that the asset is worthless or no longer useful in the taxpayer's business.

Second, the taxpayer's actions must indicate that the taxpayer has discarded or terminated its use of the asset, but the nature of the actions needed to satisfy this "abandonment" requirement will depend upon the facts and circumstances. As noted above, Treas. Reg. § 1.165-2(a) is explicit that it is not necessary for the taxpayer to relinquish title or perform an overt act of abandonment in order to claim a loss deduction. At the same time, the taxpayer's actions cannot be inconsistent with the claim that the asset no longer has any value in the taxpayer's business. See Gulf Oil Corp., supra; Brountas, supra.

In this case, the initial question is whether [redacted] became worthless in [redacted]. The failure to find commercial quantities of hydrocarbons in drilling the [redacted] well is obviously an identifiable event which could condemn the value of the petitioner's leases. Whether the [redacted] dry hole provided the petitioner with sufficient information reasonably to conclude in [redacted] that its leases were worthless is a matter of factual development. We understand that you have obtained substantial information on this issue and that your experts have concluded that the petitioner's determination of worthlessness was reasonable based on the information available in [redacted]. This clearly supports the petitioner's claim of the loss deduction in [redacted].

If the leases became worthless in [redacted], then we look to whether the petitioner's actions support its purported abandonment of the leases in that year. The petitioner paid the delay rentals in [redacted] before the drilling of the [redacted] well and relinquished title by quitclaim deed in [redacted] before the [redacted] delay rental payments were due. Although execution of the quitclaim deeds unquestionably constituted an affirmative act of abandonment, we do not believe that it was necessarily the petitioner's only act of abandonment.

The facts show that on [redacted], the petitioner issued a press release stating that the [redacted] well appeared to be dry and that the investment would likely be written off. As a result, the petitioner's stock experienced a substantial drop in its trading value on the day of the announcement. We understand that the minutes of the board of directors also reflect the probability that the leases would be charged off in [redacted]. We also understand that the taxpayer actually wrote off the [redacted] leases in [redacted] for financial accounting purposes and reported that writeoff in its first filing in [redacted] with the Securities and Exchange Commission. Assuming these facts are correct, the Tax Court could conclude that the petitioner sustained a loss on the [redacted] leases at issue in [redacted] even though it did not relinquish title until [redacted].

We recognize that it would be possible to make a technical argument that the holdings in Brountas and Gulf require a cessation of delay rental payments or some other disposition of the leases in order to claim a loss deduction. We believe, however, that the Tax Court might distinguish this case from Brountas and Gulf because the petitioner's actions here were not inconsistent with its abandonment of the leases in [redacted]. In both Brountas and Gulf, the taxpayers claimed a partial loss for potential deposits within the lease premises but continued to pay delay rentals, which preserved their rights with respect to the entire lease. Because the continued delay rental payments were inconsistent with its loss deduction, the court found that the taxpayer had not actually abandoned the specified potential deposits. In contrast, the petitioner in this case has claimed a loss for the entire lease and has not taken any actions contrary to the claimed abandonment. 7/

CONCLUSION

Based on the facts set forth in your request and additional facts communicated to us in subsequent conversations, we believe that the petitioner sustained a loss deduction in [redacted] with respect to [redacted]. In particular, under the facts stated, we do not believe that respondent should argue in this case that petitioner's loss did not occur until it relinquished title in [redacted].

7/ In the event that further factual development indicates that the petitioner has taken actions inconsistent with the claimed abandonment in [redacted], the requirements of Brountas and Gulf would likely be applicable.

If there are any questions, please contact Gerald B. Fleming at FTS 566-3345.

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Attachment:
OM 18857